

Disinflation and the Stock Market: Third World Lessons for First World Monetary Policy

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Question: Can Federal Reserve officials, quickly, and at low cost to employment and output, reduce inflation to the 2-percent target?

Two opposing schools of thought

Sacrifice Ratio (SR) School: as during Volcker, journey back to stable prices will be painful and protracted; requires fall in output in accordance with Phillips Curve (Ball 1994; Fischer 1986; Gordon 1982; Okun 1978).

This Time is Different (TTID) School: disinflation need not be protracted and costly; Fed will soon pause or start cutting rates. **TTID School** might look for comfort in Sargent (1982); in the aftermath of World War I, credible shifts in monetary and fiscal policy regimes: (a) rapidly stabilized prices, and (b) inflicted little cost on employment and output.

Trouble with the TTID view:

(1) There has been no change in US fiscal policy—federal deficit was 5.4 percent of GDP in 2022, will be 5.3 percent in 2023, and is forecast to climb, on average, through 2033 (Congressional Budget Office, 2023)

(2) Even after raising Federal Funds Rate at a record-setting pace, it is not clear that monetary policymakers, having let the inflation genie out of the bottle in the first place, have met the Sargent (1982) standard of a credible regime shift.

Both SR and TTID view suffer from a small sample problem

Hard to infer how long and costly current US disinflation path will be by comparing it to the only previous attempt to actively engineer a US disinflation this order of magnitude.

In contrast to singular focus on Volcker, this paper...

Uses historical experience of developing countries' attempts to actively engineer disinflation as a set of quasi-laboratory experiments to ask: will the Fed be able to achieve a rapid, low cost return to 2-percent inflation?

Conclusion: a soft landing by the Fed is unlikely.

In the process of drawing this conclusion, the paper makes two contributions.

First Contribution: More Power

81 disinflation programs; 21 developing countries between 1973 and 1994

56 programs directed at reducing Dornbusch and Fischer (1993) “moderate” inflations

25 programs directed at reducing Bruno and Easterly (1996) “high” inflations

Second contribution: New Methodology

Use stock market data from the 21 developing countries to provide a cost-benefit analysis of disinflation.

The central issue about disinflation is not how costly it is in the short run, but whether the costs, if any, are outweighed by the longer-run benefits (Henry 2002).

In contrast to the exclusive previous emphasis on costs, by accounting for benefits, our stock market analysis of disinflation highlights the fundamental issue of net present value.

Figure 1. The stock market responds positively to disinflation programs directed at high inflation, negatively to those directed at moderate inflation.

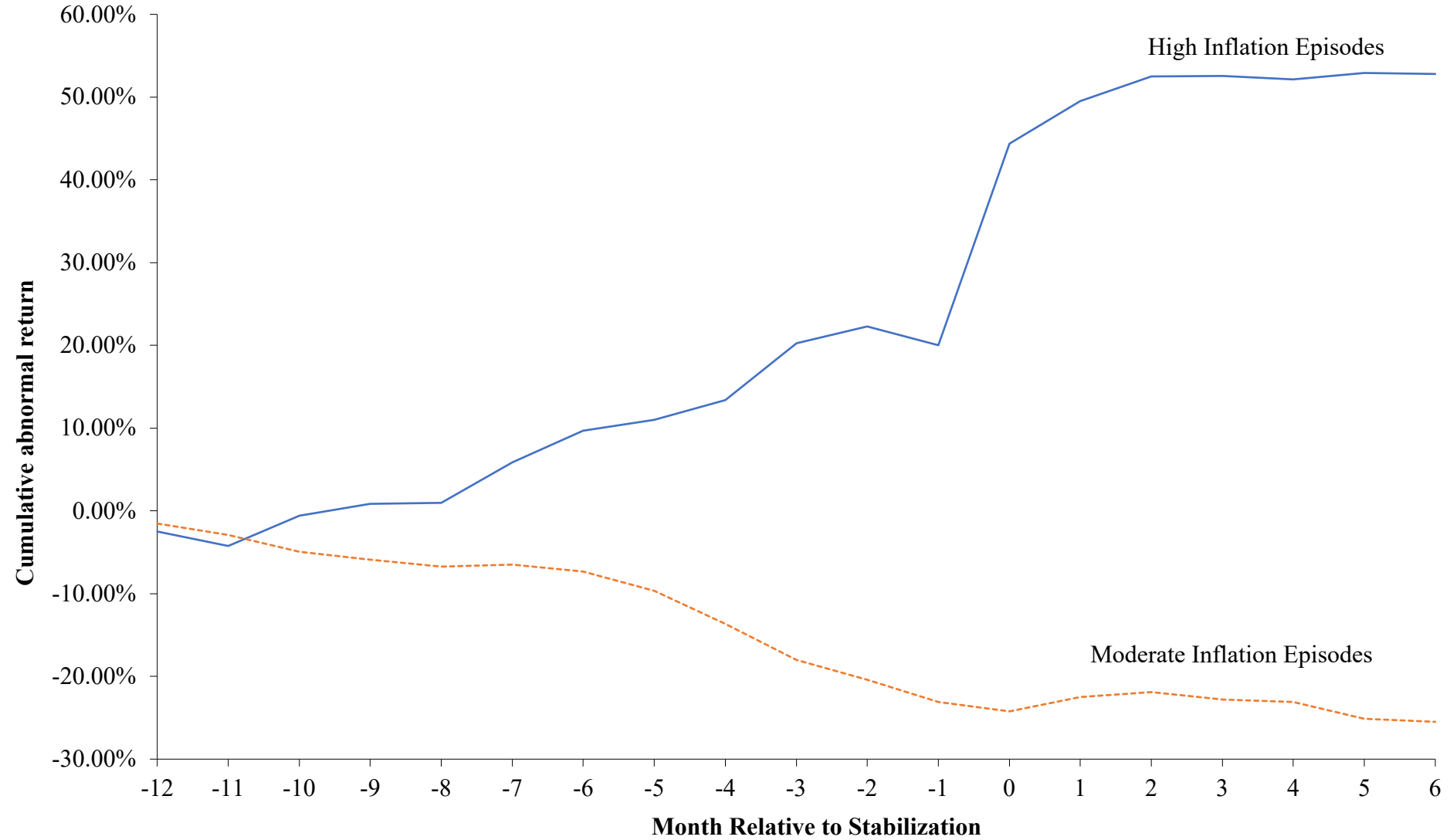


Figure 2. During successful disinflations, the transition from high inflation to moderate inflation is swifter than the transition from moderate to low.

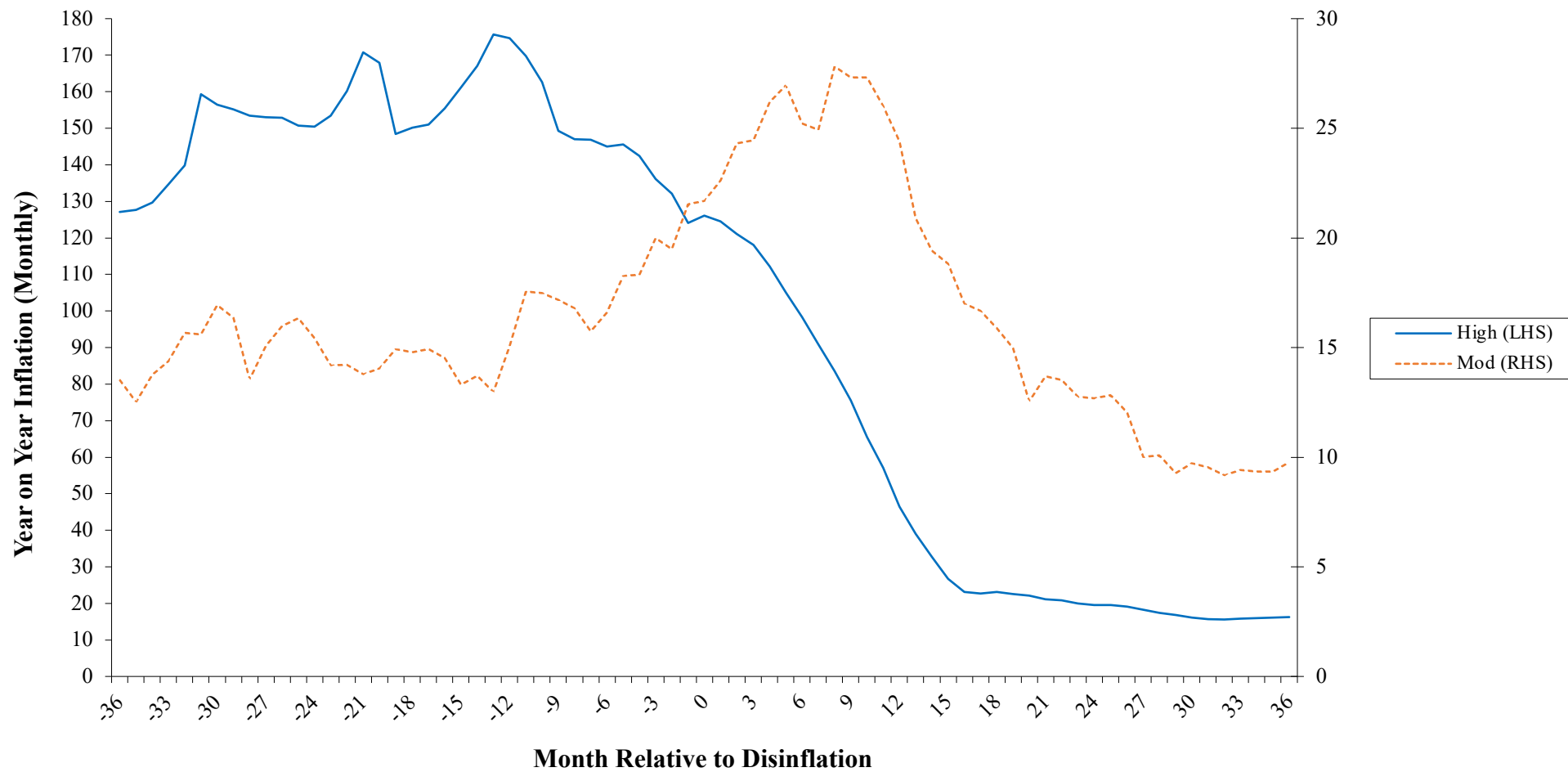
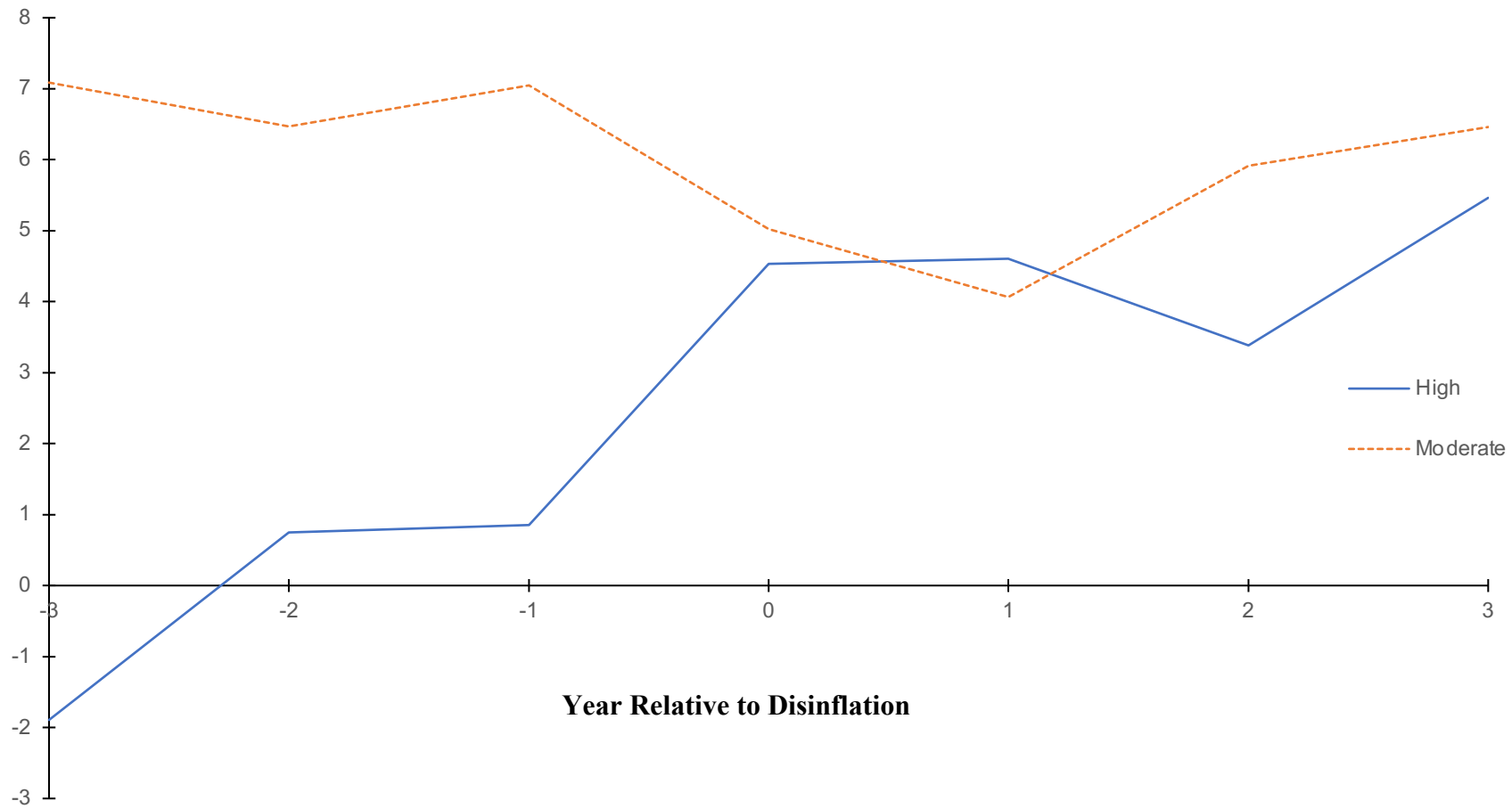


Figure 3. Growth slows during successful disinflations from moderate inflation to low inflation, but rises during disinflations from high to moderate.



Conclusion: Whether in advanced economies or the developing world, no team of policymakers has ever executed an immaculate reduction of inflation from moderate to low akin to what we have seen in the vanquishing of high inflations past.

Ironically, the stock market, which in the US has been yearning for signs that interest rates will not remain higher for longer, actually provides the strongest evidence that a quick return to the Fed's 2-percent target is unlikely. Policymakers—and financial markets—ignore this lesson at their own peril.